



DOCKET FILE COPY ORIGINAL

Dr. Edward H. Salmon
Chairman
Jeremiah F. O'Connor
Commissioner
Carmen J. Armenti
Commissioner

STATE OF NEW JERSEY
Board of Regulatory Commissioners
Two Gateway Center
Newark, NJ 07102

Celeste Fasone
Director

Office of Cable Television
(201) 648-2670

RECEIVED

AUG 25 1993

FCC MAIL ROOM

VIA FEDERAL EXPRESS OVERNIGHT MAIL

August 24, 1993

Hon. William F. Caton, Acting Secretary
Office of the Secretary
Federal Communications Commission
1919 M Street, NW
Washington, D.C. 20554

RE: IN THE MATTER OF

MM DOCKET NO. 93-215

IMPLEMENTATION OF THE
CABLE TELEVISION CONSUMER
PROTECTION AND COMPETITION
ACT OF 1992

COST OF SERVICE STANDARDS

Dear Mr. Caton:

Enclosed please find an original and 12 copies of the Staff Comments of the Board of Regulatory Commissioners for filing in the above matter. We have included copies for the Chairman, each Commissioner, Ms. Ellen Schned and Mr. Alan Aronowitz.

Kindly place the Board and the Office of Cable Television on the service list for this docket.

Please return one copy marked "filed" in the enclosed addressed, stamped envelope.

Thank you for your consideration.

Very truly yours,

Celeste M. Fasone
Director

CMF/zdc/am

Enclosures

No. of Copies rec'd
List A B C D E

0411

Staff Comments
on
Notice of Proposed
Rulemaking on Cost of Service Standards
Adopted July 15, 1993
FCC MM Docket No. 93-215

The Staff of the New Jersey Board of Regulatory Commissioners ("Board") is pleased to submit these comments to assist the FCC ("Commission") in the implementation of the Cable Act of 1992.

The Board believes that the Commission should be pro-active and aggressive in its efforts to stimulate competition, and in the situation where competition does not exist, be equally pro-active and aggressive in seeking to simulate a competitive result.

Board's Staff believes that the aim of cost of service rate evaluation in the overall cable regulation scheme should be to permit rates that exceed the benchmark to be reviewed for reasonableness in light of that cable system's actual costs. (*comment to paragraph 7).

The Board's Staff believes that the proper level of cost averaging for the purpose of such cost of service showings is

*All paragraph references are to NOPRM, Docket No. 93-215 adopted July 15, 1993

at the cable system level. This level best represents the actual cost of service delivery to the typical cable subscriber. The system level most appropriately represents the actual physical plant which provides cable service. In our statewide jurisdiction, most cable systems cover more than one franchise area and the trend is toward consolidation by elimination of head end facilities as technology improves. It is not proper for cost data to be submitted by franchise area in our opinion, unless the entire cable system is contiguous with that franchise area. Current practice in our jurisdiction is that tariffs and financial data are submitted for cable systems, rather than individual municipalities or franchise areas. In sum, costs should not be averaged above the level of the local operating system since these costs best represent the actual cost of service delivery. Use of cost data of above system level may reflect improper corporate organizational and non-cable expenses.

In general, the Board's Staff believes that the traditional, well known and court approved standards of determination as used in rate base/rate of return ratemaking are the most appropriate in this context of cost of service showings. Some of these standards are as follows:

- "used and useful" standard for inclusion of items in rate base.
- "reasonable rate of return" as judged by current capital market conditions for equity return.

- "straight line depreciation" over expected plant and equipment lifetime to set depreciation allowance.

The Board has extensive experience with these concepts from its ongoing duties in the area of traditional public utility regulation. On a national level, these regulatory concepts have a extensive legal history and are generally well known.

The Board's Staff believes application of these principles and methodologies are proper in this cost of service context. Board's Staff strongly believes that the cable operator must bear the burden to demonstrate its costs and justify rates above the FCC benchmark rates.

We have enclosed (Attachment A) a relevant portion of the previous comments of the Board to the FCC, dated January 26, 1993 under MM Docket No. 92-266 which discusses further cost of service methodologies and allowances which we believe are proper in this regard and are consistent with traditional rate base, rate of return methodologies.

In responses to Paragraph 12 of the NOPRM, Board's Staff agrees that cost based evaluations and determinations are extensive, lengthy and expensive proceedings for the cable operator, local franchising authority and interested parties. Expert testimony is often required. In light of this fact, the Commission should standardize as much as possible any data, requirements and findings, such as acquisition cost and useful

life for standard equipment such as converters, in order to avoid essentially the same proceeding, facts, and decision being repeated in every cable rate making jurisdiction. The use of FCC mandated forms, completed and designed to lead to a clear conclusion is recommended (paragraph 19). Common decisions such as an industry wide rate of return should be made annually by the FCC and mandated for use in all local proceedings. The Commission is equipped to make decisions such as rate of return and regularly makes these decisions in the course of telecommunications proceedings.

With regard to paragraph 17, to limiting frequency of filing for cost of service showings, the Commission suggests once a year limitation. Board's Staff recommends a two year limit to eliminate the burden of repetitive filings, except in the case of a substantial system physical rebuild or other technological upgrade involving all subscribers.

Board's Staff agrees with the Commission comments at paragraph 18 that cost of service showings seeking to justify rates higher than existing rates, absent a demonstration of special circumstances or extraordinary costs, should be barred. Only the most extraordinary situations, such as a total system rebuild, should be considered as an exception.

In regard to paragraph 19, Board's Staff strongly believes that an FCC prescribed cost of service form and associated worksheets embodying the cost of service standards, cost allocation and cost accounting requirements be designed, adopted and mandated for use in all cost of service proceedings.

This would save time and money in discovery and informational proceedings. The administrative burdens of franchising authorities would be eased.

In regard to paragraph 22, Board's Staff believes that no transitional rules, financial allowances or timetables should be permitted in regard to the provisions of cable rate regulations or cost of service showings. Such rules will create additional confusion and difficulty of application. Cost of service rules and principles should be clearly applied.

In regard to paragraph 23, Board's Staff strongly believes that only expenses related to the direct provision of regulated cable service be recovered through regulated cable rates. The design of accounting standards and FCC prescribed cost of service forms should especially exclude all other expenses. Affirmative tests for allowable expenses or certifications of these expenses should be included to assure this result.

With regard to paragraph 24, Staff agrees that inclusion of the costs mentioned therein as operating expenses is proper. We further agree the exclusion of lobbying expenses, contributions for charitable, social or community welfare purposes, membership fees in social, service and recreational or athletic clubs and organizations, and penalties and fines paid on account of violations of statutes and rules mentioned in footnote 25 is proper. Board's Staff agrees that programming expense is not a cost element for inclusion in rate base. Furthermore, a profit margin or markup on programming expense for existing

programming is not proper in a cost based regulatory scheme. Such a markup should only be considered as an incentive for new programming introduced after the approval of initial rates, if at all.

With regard to paragraph 27, straight line depreciation be mandated, and that the useful life for such depreciation be determined by generally recognized industry standards. Straight line depreciation is traditionally accepted as the best methodology for matching the use of the asset with the current customer. This determination of depreciation and useful life should be made yearly by the Commission and be mandated nationwide for all proceedings for all standard equipment items. This Commission mandate would save time and expense in each local proceeding and produce standardized results and records making an appeal of local determinations to the Commission much easier.

In regard to paragraphs 32 and 35, the Board believes that the rate base should be determined by the used and useful standard and only for plant and equipment supplying regulated services. Necessary adjustments should be made by subtracting costs based simply on the percentage of non-regulated channels. The valuation of the rate base should then be strictly on the basis of original cost as supported by original construction process, documentation and work orders. The Commission should apply this standard strictly in both initial and follow-up cost of service showings.

The issue of "excess" acquisition costs (over original cost) may arise in the cable industry. As in traditional

regulatory practice, however, excess acquisition costs should be strictly excluded from rate base. Excess acquisition costs is the excess of the purchase price covering the acquisition of the assets (land rights, structures, buildings, distribution plant, etc.) over and above the original cost reflected in the seller's books of record. Board's Staff believes these costs should not be permitted as "goodwill" expenses or accruals. Excess acquisition costs should not be permitted as an intangible asset, as would be the case as with customer lists or franchise rights. This would entail acceptance of acquisition prices based on negotiations and speculation at various market conditions and times. These prices can not be realistically reviewed by objective standards as prices may represent expectations of monopoly rates, which the Cable Act was enacted to remedy. The Commission should use an objective standard capable of easy and fair application. The standard of original cost is well known and widely used. In the alternative, should the Commission determine that goodwill be allowed, Board's Staff believes that it should be reviewed on a case by case basis by the local franchising authority.

Finally, the operator should clearly bear the burden of proof of all plant and equipment under the used and useful standard and original cost valuation. Engineering certification and original cost documentations should be required as backup in the FCC prescribed cost of service forms and worksheets.

In response to paragraphs 44 and 45, the Commission seeks comment in regard to the inclusion of working capital in rate base. Allowance for working capital should depend on the

billing practices of the cable operator. In New Jersey, cable operators bill in advance for service on a monthly basis. With such practices, there should be no allowance for working capital since the operator has funds at the time of expenditure. If billing is done in arrears, then working capital allowance is proper. Should an operator wish to justify a working capital allowance, that operator should bear the burden of proof with a detailed lead/lag study.

Addressing the Commission's position on rate of return issues, Staff believes that in the interests of economy and administrative uniformity, the Commission should on an annual basis, specify (as described previously) a yearly overall rate of return to be applied in all cable cost of service proceedings. The credit market and investor expectations of acceptable returns are set on the basis of national, even international credits markets and conditions.

Board's Staff agrees fully with the Commission's intention in paragraph 46 to establish a single rate of return for provision of regulated cable service by all cable operators for the purpose of setting rates on a cost of service showing. The savings across the country will be substantial. The exact methodology is best left to the discretion of the Commission as the circumstances and economic situation may vary. Board's Staff believes the approximate range of rates of return as shown in paragraph 52 is proper. Further, in recent New Jersey Board of Regulatory Commissioner's proceedings for utilities, the Board has permitted a range of overall rates of return on equity consistent with the range specified by the Commission.

Additionally, a cable operator should be permitted to seek a rate of return above that set by the Commission, if it can clearly demonstrate its economic situation justifies a higher level.

It is recommended in determining an approximate rate of return for the cable industry a weighted average of approximately 70% for the cost of debt and approximately 30% for the cost of equity be used. The cost of equity should be based on current capital market conditions and the cost of debt should be the embedded cost.

In regard to paragraph 54, Board's Staff supports fully the conclusion that the Commission should evaluate the performance of provision of cable service, subject to regulation under the cost of service standards, including the prescribed rate of return which is adopted in this proceeding. Financial performance of the operator should be measured on costs presented in accordance with cost of service requirements as set in this proceeding. The Board's Staff recommends that the historical test year as adjusted for known and measurable changes be used for cable rate making purposes. This measure provides the most accurate reporting of data and provides necessary flexibility. In general, the test year should also be a calendar year so that financial data is most easily assembled by the operator. In addition, a calendar year is suggested in order that the information received through the cost of service showing will be the comparable to the prescribed Commission's annual report.

With regard to the financial accounting requirements contained in paragraph 58, Staff recommends that the FCC

prescribe a nationwide uniform system of accounts mandated for use by all cable operators in all filings including both benchmark and cost of service showings. It is suggested that the accounts be written to identify local operating expenses in order to cover cases of possible MSO ownership and control, and to provide for cost allocations between regulated and non-regulated cable services. Both the benchmark and cost of service forms should require use of the uniform system of accounts along with all backup information required by or attached thereto.

In paragraph 67 of the NOPRM, the Commission indicated it would design rules regulating affiliate transactions and preventing improper cross-subsidization between regulated and non-regulated services including cable programming services. Board's Staff supports these goals and believes the definition contained in footnote 67 is proper. Limiting cost increases of affiliated programming to the rate of inflation as a price cap is a sound solution (footnote 70) to the difficulties of local franchising authorities being forced to examine many complex programming purchase arrangements. For cost of service showings, footnote 71, requiring application of GAAP to affiliate costs and requiring cost of service principles be applied to affiliate contracts themselves, is a proper solution. However, the burden of such application and documentation must fall on the operator, who has all relevant information for such work.

As set forth in paragraph 71, the Commission is seeking streamlined alternatives to the cost of service approvals. Board's Staff believes such alternatives as proposed are acceptable, only if the factors for add-ons or additional

allowances beyond the benchmark are fully documented and subject to clear guidelines based on physical facts, such as extremely rural, high cost areas or high technology upgrades. These factors can be set forth as the sole issues in limited cost of service showings concentrating on these issues alone.

In response to paragraph 79, Board's Staff believes that the Commission should annually prescribe on a yearly basis a set equipment charge to subscribers for all cost of service showings nationwide. This standardized equipment charge to subscribers should be based on the average cost of acquisition for each class of equipment. There is a limited number of types of equipment, each with a limited number of suppliers. Imposition of such standardized equipment charges by the FCC will save time and money in thousands of local proceedings and achieve streamlining in the cost of service proceedings as sought by the Commission.

In regard to paragraph 81, Board's Staff repeats the position of the Board as stated in its Comments to the FCC Rate Regulation NOPRM, dated January 26, 1993 on page 16, that the GNP-PI should be reduced by a static productivity offset, such as 2%. The productivity offset, such as 2% is meant to reflect the known benefits of technology improvement occurring in the cable industry. The economic benefit of such improvements and efficiencies are fairly passed to the cable subscriber through the productivity offset mechanism. Board's Staff believes that the Commission might adjust this offset, if necessary on a yearly basis, but it should be clearly stated that such an index and offset approach could result in rate decreases and that such decreases are intended.

In regard to paragraph 86, Board's Staff comments that basic cost of service principles should be strictly and uniformly applied. This includes the application of such principles for all costs, including external costs in cost of service filings.

The Board's Staff finally would like to repeat the position of the Board in its comments in MM Docket No. 92-266, stressing the need for a uniform system of accounts. Its logical conclusion is a standardized annual report based on the uniform system of accounts (paragraph 88). The draft format proposed as Appendix B is a good beginning. The annual report should be specific enough to distinguish revenue and cost allocations between regulated and non-regulated cable services, between cable services and other types of telecommunications service, and between the revenues and costs of the regulated cable operator and possible MSO affiliates, up or down the corporate structure. Furthermore, the uniform system of accounts should be used for all FCC cable rate regulation filings be they benchmark, cost of service, or annual reports and for all worksheets and backup information requested in each filing.

The Staff of the Board of Regulatory Commissioners thanks the Commission for this opportunity for input and congratulates the Commission and its Staff on its work in the area of rate regulation under such time constraints.

ATTACHMENT A

The first step in arriving at the revenue requirement is a determination of the cable operator's costs, the second step is the determination of the level of investment on which the stockholders/owners are entitled to earn a return, and the third step is the determination of a reasonable rate of return for the owners to earn on their investment. These determinations result in the identification of the cable operator's revenue requirement, which can be expressed in terms of the following equation:

$$RR = E + D + T + r(RB)$$

Where:

RR = Revenue Requirement

E = Operation and Maintenance Expenses

D = Depreciation Expense

T = Taxes

r = Rate of Return

RB = Rate Base

Where:

$$RB = v - d$$

v = Value at Original Cost

d = Accumulated Depreciation

The Revenue Requirement is equal to the cost-of-service which includes an appropriate return on investment. A monthly subscriber rate equals the revenue requirement divided by the actual number of subscribers at the end of the year for each

cable operator, divided by 12.

The above mentioned formula to determine the rate base of the cable operator, however, does not include certain items which are valid adjustments to the Rate Base in the determination of rates. The Board believes that the following adjustments should be made:

1. Items to be added to Rate Base:

- a) Construction Work in Progress
- b) Working Capital (if appropriate)

2. Items to be deducted from Rate Base:

- a) Customer Deposits
- b) Investment Tax Credit
- c) Deferred Taxes
- d) Contributions in Aid of Construction

2. Rate Base

In the regulation of traditional utilities the Board has applied the "used and useful" approach in the determination of rate base. Thus the Board agrees with the Commission's proposal of applying the "used and useful" standard to the original construction cost of the assets dedicated to service. The Board is also of the opinion that property held for future use should not be included in the Rate Base since it is not "used and useful".

3. Goodwill

Goodwill is an intangible asset and should be treated as such in the books of account. It is not cost-based and should not be permitted in Rate Base or in any expense account. Goodwill is not a known and measurable change and any cable operator selling its business could set its own price. Allowing Goodwill to be included in cost based rates would allow cable operators to recover their own expectations of revenue from subscribers. Therefore, it is recommended that Goodwill not be allowed in Rate Base or expensed. However, should the Commission determine to allow Goodwill in a cost of service showing, it should be reviewed on a case by case basis.

4. Customer Equipment

The Board is of the opinion that the original cost of customer equipment should be included in the Rate Base, and a reasonable return be allowed. Furthermore, the Board believes that when the equipment is used and installation complete, customers should be charged the original cost of equipment, plus an allowable rate of return.

5. Cost of Capital

The Board recommends that the cost of capital be determined by calculating an overall rate of return. This is similar to the approach used for other regulated industries. In determining the allowable rate of return a weighted average of

the cost of debt and the cost of equity should be used. Our initial impression based on New Jersey experience is that the weighted average be in the range of 60% to 70% for the cost of debt and 40% to 30% for the cost of equity. The cost of debt should be the embedded cost of debt and equity should be based on current capital market conditions.

6. Depreciation

The straight line depreciation over the expected life of the plant investment is the appropriate method to be utilized. Generally, depending on type of equipment, the Board recommends that the useful life be an industry standard.

The Board believes that the information received from the 850 cable systems will include existing book reserves for depreciation and that these accumulated depreciation reserves were likely determined using other than straight line depreciation. The Board is of the opinion that the cable system should reflect straight line depreciation and both the accumulated depreciation and the depreciation expense should be adjusted for accelerated methods of depreciation. Therefore, it is suggested that the depreciation be adjusted accordingly to reflect these accelerated forms of depreciation. It is suggested that if a cable system uses an accelerated form of depreciation, the estimated straight line depreciation expense be calculated by using the Original Cost of the Fixed Assets divided by the Useful Life Years of Fixed Assets. In addition, it is suggested that for these cable systems, the accumulated depreciation be adjusted to reflect the straight line method of

depreciation. One way of accomplishing this may be to take the difference between the estimated straight line depreciation expense and the accelerated depreciation expense. This difference should be multiplied by the Useful Life Year of Fixed Assets and then added to the accumulated depreciation being booked by the cable system.

7. Operating Expense

For a cable operator serving a single franchise and having no other operations, the Board believes that would be easy to trace the type of expenses by creating a uniform system of accounts which shows detailed accounts of expenses.

For multi-franchise cable operators, the Board suggests that the operator should maintain separate books by system or should be recorded in the books by system. This method eliminates the problem of identifying the origin of expenses.

It is recommended that the cable operators identify in its book of accounts the portion of expenses directly attributable to regulated and unrelated areas of business.

For those expenses which are not directly identifiable and cannot be assigned directly, such as corporate expenses, it is suggested that it should be allocated by dividing the cost by the number of channels.

8. Design of Rates

The Board believes that the Commission's proposed method of identifying the portion of the revenue requirement recoverable in basic service rates by calculating the basic tier costs, less direct channel revenues, plus an allocation of other costs based on relative number of channels in use is the preferred method, rather than an overly cumbersome alternative.